THE SOCIAL MARKET ECONOMY

By Norman Barry

Introduction

The collapse of Communism in the regimes in Eastern Europe and the former Soviet Union has brought forth a plethora of alternative political and economic models for the reorganization of those societies. The vacuum that has been left could be regarded as an ideal laboratory for the testing of competing theories, and the temptations to experiment with the more benign forms of constructivist rationalism[1] are likely to prove irresistible. If liberal capitalism is to be successfully created, it will clearly not have the same biography as it has had in the Western European and Anglo-American countries, where its emergence was the result of slow evolution: often its appearance and survival were due to a quite fortuitous combination of circumstances. In those countries it was not the result of any deliberate democratic choice but the outcome of a happy confluence of traditional rules and customary practices, and the participants in them had little idea of the form of the system that they were creating. Indeed, ideological sanctification was almost an afterthought, and democratic approval was belated and in most cases not enthusiastic.[2] Britain was a liberal capitalist society, and possessed the necessary body of private law, some time before the franchise was significantly democratized (which did not occur until 1867). It is, of course, recent theoretical and empirical research which has revealed that the political choice mechanisms that developed haphazardly after the success of the market are a potential threat to it.[3]

[1] "Constructivist rationalism" designates that style of thinking which supposes that it is possible to impose on a social system a pattern of social and economic organization which is derived from a notion of human reason uninformed by experience and the lessons of tradition. It is most clearly exemplified in systems of centralized economic planning which dispense with the price signals provided by spontaneous markets. Constructivist rationalism presupposes that a single mind or institution is capable of organizing the necessarily dispersed knowledge in society. Its most articulate critic is F. A. Hayek, who does not limit his critique to rationalistic economic planning but includes refutations of attempts to design whole legal systems from *a priori* principles. See his *Rules and Order*, vol. 1 of *Law, Legislation, and Liberty* (London: Routledge and Kegan Paul, 1973).

[2] Though, of course, the U.S. has been, with the exception of slavery, a liberal democracy since 1789.

[3] James Buchanan's innovative works are especially relevant here. See his *The Limits of Liberty* (Chicago: University of Chicago Press, 1975), and *Fiscal Theory and Political Economy* (Chapel Hill: University of North Carolina Press, 1960); James Buchanan and Gordon Tullock, *The Calculus of Consent* (Ann Arbor: University of Michigan Press, 1962); and James

The former Communist countries are not the lucky beneficiaries of a spontaneous order but the penniless inheritors of a past experiment in constructivism. A number—for example, Poland, Czechoslovakia, and Hungary—can attempt to recapture an order of either incipient or developed market capitalism that was shattered by Communism, and another, the former East Germany, can live for a while almost parasitically off the economic and intellectual capital of its partner in a natural but unexpected political marriage. But the immediate task for them all must be to create, almost in a "bootstraps pulling" manner, not merely new economic arrangements but also the set of intermediary or auxiliary social institutions of civil society which are essential for the maintenance and reproduction of economic order. Given the variety of cultural traditions on which Communism was imposed, there can be no one universal panacea for the problems it has bequeathed, though there are permanent constraints within which all must operate.

One must assume that the "market versus the state" debate is over. The immense calculational (and ultimately epistemic) problems involved in a socialist order which treats the economy as one giant firm have been demonstrated many times as a matter of theory[4] and these theories were corroborated with grisly repetition in reality. One must also dismiss the once fashionable convergence thesis,[5] i.e., the claim that fundamental similarities in the production problems that confront market capitalist and centrally planned economies will generate some economic hybrid that embodies the virtues of each. But there was no such convergence, rather the gradual admission from socialists that their fundamentally different planning method failed dismally in comparison to the market in the solution of the same problems that confront all economies. Of these, the most important are scarcity and the efficient allocation of resources. Without an internal price mechanism to indicate scarcities, planning authorities were compelled to rely on the international market to provide the necessary economic information. In any case, resources were not primarily allocated to satisfy consumer preferences but simply to fulfill the arbitrary dictates of political rulers. Shortages of basic goods were therefore an endemic feature of life under planned systems.

The absence of entrepreneurship in planned economies, and the inadequacy of all the surrogates (such as the replacement of profit-seeking

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Buchanan and Richard Wagner, *Democracy in Deficit* (New York: Academic Press, 1977). See also Gordon Tullock, *The Vote Motive* (London: Institute of Economic Affairs, 1976).

[4] Ludwig von Mises, "Economic Calculation in the Socialist Commonwealth," in *Collectivist Economic Planning*, ed. Friedrich von Hayek (London: Routledge and Kegan Paul, 1935), pp. 87–130; Hayek, "Socialist Calculation," in Hayek, *Individualism and Economic Order* (London: Routledge and Kegan Paul, 1948), pp. 119–208; Don Lavoie, *Rivalry and Central Planning: The Socialist Calculation Debate Reconsidered* (Cambridge: Cambridge University Press, 1985).

[5] See John Kenneth Galbraith, *The New Industrial State* (Boston: Houghton Mifflin, 1978).

private agents by paid managers) for this essential mechanism of coordination that were tried, revealed that the market and the plan are radically different types of economic organization. Furthermore, there is no evidence that the collectively owned industrial systems overcame that "alienation" between the worker and his product that was alleged to be a feature of private enterprise.

Yet the triumph of the market over the state is not an automatic endorsement of all the market systems now prevailing in the Anglo-American portions of the West, nor an intellectual license for their immediate transplantation to former Communist regimes, leaving aside the cultural factors that may inhibit the success of any proposed transplantation. It is not assumed by the inhabitants of these regions that the ideal of liberty is best illustrated by the Anglo-American conception or that the form of property which is most desirable for them is that which emerges from self-interested action in anonymous markets subject only to abstract rules. Above all, it cannot be assumed that notions of individuality and community which detach agents from all but the minimum of social bonds are likely to be attractive to populations which have little or no experience of the subtlety of these abstract rules. It would be the high point of naiveté to suppose that an economic order bounded by contract, tort, and the intricacies of corporate law can be grafted onto communities which have little experience of capitalist legality. This is especially true of Russia, whose nascent (but potentially successful) commercial order was swept away by the Revolution of 1917 and its aftermath.

Indeed, the vacuum created by the collapse of Communism is likely to feature pockets of anarchy in which the entrepreneurial spirit, subject to no legal restraint, and operating in the absence of specified property rights, is certain to function in a malign manner. Indeed, it would appear that this is already happening.[6]

It takes some persuasive art to convince inhabitants of communities which are still pervaded by the most primitive notions of social justice that there is both an economic rationale to pure entrepreneurial profit (i.e., profit that accrues not to a factor of production, labor, but to mental alertness to wealth-creating opportunities) and a moral justification for it.[7] This is especially so when those most alert are likely to be former officials of the Communist regime. Under Communism, individuals were alienated from the system because to them it appeared to be a mechanism for enhancing the interests of the Communist Party, whose members masqueraded as representatives of the public. For this reason it was accorded little legitimacy. However, this alienation is likely to be reproduced even if an inchoate capitalist legal system were to replace anarchy,

[6] See reports in *Express and Chronicle*, Moscow, March 3-10, 1992.

[7] Israel Kirzner, *Discovery, Capitalism, and Distributive Justice* (Oxford: Blackwell, 1989).

since the immediate beneficiaries of it will most probably be those who acquire their assets by force.

In capitalist regimes the discovery of a profitable opportunity by a creative economic agent is regarded as legitimate if, and only if, existing legal forms and established private-property rights are respected. However, under post-Communism, entrepreneurial activity is almost certain to involve the seizure of hitherto commonly held assets by the *nomenklatura*. At the moment there are simply no rules of just acquisition, so a perverse form of privatization is taking place. This will, of course, prevent the legitimization of capitalist processes.

Within the range of possible market alternatives to Communism, the Anglo-American model (I refer to it simply as a model so that the very serious depredations to it that have occurred in this century can be conveniently ignored) is not the only one. It is rivaled by market socialism, the Scandinavian welfare state, and the original German doctrine of the social market economy. All three have been offered to former Communist regimes, although it is surely obvious that each depends upon the prior establishment of a predictable and stable constitutional and legal order. (However, it should not be thought that legal and economic orders are theoretically separate, that a neutral political order can be constructed which can accommodate any economic system.) There is a fourth alternative, South East Asian capitalism, but I have limited this inquiry to Anglo-American and West European models, since it is these that are being offered to former Communist regimes. This is probably because some of these countries, but by no means all, have histories and social structures which are, or were at one time, close to the mainstream European experience.

The first of these alternatives, market socialism,[8] is deeply flawed in theory, and has proved to be quite inadequate in practice. The only serious examples of its implementation are Yugoslavia and the voluntary system in Mondragon in Northern Spain.[9] Both are characterized by lower productivity than capitalist orders operating with similar natural resources. In Yugoslavia the power quickly shifted from workers to managers. The idea that there can be collective ownership and direction of resources alongside an individualistic market signaling system for labor and consumer goods is no more than an attempt to "square the circle."[10] In its efforts to simulate the perfectly competitive equilibrium model of resource allocation, market socialism enervates those human faculties that enable

[8] The most recent argument for market socialism is contained in David Miller, *Market, State, and Community: Theoretical Foundations of Market Socialism* (Oxford: Clarendon Press, 1989).

[9] See Brian Chiplin, John Coyne, and Ljubo Sirc, *Can Workers Manage?* (London: Institute of Economic Affairs, 1977).

[10] Antony de Jasay, *Market Socialism: A Scrutiny* (London: Institute of Economic Affairs, 1991), p. 22.

actual markets to work toward equilibrium. Again, entrepreneurship is the vital ingredient, for without the possibility of profits (as distinct from payments to a factor according to its marginal productivity) to lure actors, the necessary coordination will not take place and economizing opportunities will be missed. If capital is to be allocated by the state, how are its officials to *know* where the best investments are? Almost certainly, entrepreneurship (a fundamental category of human action) will reappear in a less benign form, i.e., in the search for the profits that accrue from political activity.

If workers are to be forbidden from owning individually any of the share capital of the enterprise, then rationality dictates that surpluses will be consumed in the form of wages, with the consequent lowering of investment. This is especially so if consumption and investment decisions are "democratized." Yet if workers are permitted to own resources, and these are marketable, then a version of orthodox capitalism will quickly emerge, and with it the familiar inequalities that market socialism is supposed to eliminate.

The two other models, the Scandinavian welfare state and the German social market economy, are often confused—largely, I think, because the actual practice of the West German economy began to resemble the Swedish experience, from at least the 1960s, in significant ways. But they are theoretically different. The Swedish system originally involved the imposition of heavy welfare responsibilities on a more or less unhindered market system. It was a market system characterized by almost exclusively private ownership in the means of production. It was and is, in effect, a "transfer" state in which political intervention took the form of the establishment of extraordinarily costly welfare services.[11]

If a measure of personal liberty is the amount of income left in the hands of individuals, then by the 1980s Sweden had become a not particularly free society. In many areas, including health, pensions, education, and aspects of family life, personal responsibility for action had been removed.[12] Furthermore, the Swedish system had no comprehensive theory of the social welfare state, a theory that would connect social, legal, political, and economic life in both its explanatory and normative aspects. It was reasonably effective when central government left the economy alone and pursued its own welfare policies, preserving a rather unlikely division of labor. However, the encroachment of the state into

[11] Eric Brodin, "Collapse of the Swedish Myth," *Economic Affairs*, February 1992, pp. 14-22.

[12] Swedish socialist thinkers (including Gunnar and Alva Myrdal) regarded the bourgeois family as an obstacle to the full realization of the welfare state. Hence, a whole range of family services, including home allowances, child care, and home care for the ill and elderly, are provided by the state. In addition to zero-priced medical care, everyone on sick leave gets 90 percent of their wage without a doctor's certification. Furthermore, incentives exist for unmarried motherhood, the right of parental discipline is severely restricted by law, and social workers have extensive powers to interfere with family life.

more and more areas of social life has made the terms of the contract economically disadvantageous.[13] Although large-scale nationalization has been eschewed, the state has taken significant stakes in industry, notably pharmaceuticals and steel.

Marginal income tax rates have been as high as 92 percent, and they are rarely less than 70 percent. Furthermore, the burden of company taxation has increased: until the mid-1970s it was exceptionally low, but since then successive Social Democratic governments introduced taxation on "surplus" profits (although this, at 20 percent, is at least an improvement on the original intention of confiscating all profits above a certain level). Also, there was a scheme to return the tax on surplus profits to the trade unions to invest in the shares of listed companies. This would, if implemented in full, lead eventually to the nationalization of Swedish industry. A modified version was introduced in 1982, but it was not successful. Nevertheless, it is a constant threat to private enterprise and has led to a massive increase in overseas investment by Swedish firms.[14]

The combination of high labor costs, a bloated public sector, and a very expensive welfare state has produced a marked decline in the Swedish growth rate. In the century 1870 to 1970, only Japan grew faster than Sweden, but in the 1980s, the rate had fallen to about 2 percent per annum. The conservative coalition government which was returned in 1991, after a long period of almost uninterrupted Social Democratic rule, specifically rejected the Swedish model as a "third way" between socialism and capitalism. It is in the process of dismantling parts of the welfare state and selling off state holdings in private industry.

I. Origins of the Social Market Economy

A much more plausible model for former Communist regimes to follow is that provided by the German social market economy—or at least the model as it was described by its most prominent theorists. Although there are crucially important differences between the position of postwar Germany and former Communist regimes today, there are enough similarities to make some meaningful comparisons. Both areas experienced ruinous central planning and wrecked monetary systems. More important is the fact that the theory of the social market economy included significant modifications of pure laissez faire: variations which might make capitalism more palatable to societies struggling to end central planning. As I shall indicate below, in many respects some of the former Communist regimes are in such a perilous state that mere survival is their most immediate problem. But in some countries, notably Czechoslovakia, Poland,

[13] See Gabriel Stein, "The Death of the Swedish Model," *Policy*, vol. 7, no. 1 (1991), pp. 2-5.

[14] *Ibid.*, p. 4.

and Hungary, some version of the social market economy appears to be appropriate.

In the original German *Soziale Marktwirtschaft* (social market economy), there was no attempt to locate some middle ground between the extremes of collectivism and the market economy. Ludwig Erhard, the economic architect of the regime and accomplished theoretician of it, specifically precluded the Scandinavian model.[15] He argued that it was too statist and that not only would its implementation be very costly in the circumstances of postwar Germany, but it would have a deleterious long-term effect on personal responsibility. It was not that Germans were unused to extensive social welfare; they had had it since Bismarck's day. The point was that for the theorists of the social market economy there were interrelations between economy and society, feedbacks from social institutions to personal action, which required explanation: society and economy, in other words, are not hermetically sealed entities. The theorists of the social market economy sought an account of the *Wirtschaftsordnungspolitik*, or the order of economic society. Such a comprehensive theory would explain economy, polity, and society and account for their interrelationships.

The social market economy is in principle the doctrine that private property and the price system are the best means of exploiting scarce resources for the maximization of human well-being. It enjoins a limited state with the primary responsibility of securing law and order and a stable monetary system. That state is in theory precluded from the use of Keynesian fiscal policies to cure unemployment, since the theorists argued that this is primarily a microeconomic problem caused by rigidities in the labor market, normally trade-union power. However, the social market economy differs, as we shall see, from classical liberalism in that its theorists were skeptical of the claim that a market system is always self-correcting, especially in relation to the emergence of monopoly power. The legal system would have to be designed so that freedom is preserved, and not threatened, as these theorists claimed it would be, by untrammeled markets.

They also believed that the state had certain welfare responsibilities for the innocent victims of necessary economic change. But in the theory of the social market economy, if not in the practice of West German policy making, the state should not take a role in those areas of welfare which most individuals can handle for themselves, e.g., in pensions and other forms of social insurance. The postwar West German government inherited a range of state welfare functions which continued, even though the purists were later to object to their extension. They thought that this would have feedback effects, not only on productivity but also on indi-

[15] Quoted in Hans-Joachim Braum, *The German Economy in the Twentieth Century* (London: Routledge, 1990), p. 178.

vidual autonomy. Thus, the "order" of economic society could only be maintained by a judicious mixture of carefully designed welfare measures and regulatory devices which are required to modify and correct laissez-faire economics.

The obvious success of postwar Germany has led many people to think that the theorists got it right, that the rigors of the free market were softened by socially oriented institutions and policies without those arrangements weakening at the same time the productivity of the exchange system or undermining the autonomy of its inhabitants. It is not then surprising that the social market economy has been recommended for former Communist regimes. This was explicitly so in the debate leading up to German reunification and in the case of Hungary's attempts to slough off the remnants of Communism. No doubt the phrase was used rhetorically, as an anodyne slogan designed to induce into markets populations which were alienated by Communism yet fearful of an unknown capitalist future.

The theory originated during the prewar and war periods. In Germany a remarkable group of social and economic thinkers had been working out a blueprint or rational plan for the post-Nazi and postwar reconstruction of the country. Although they are collectively known as the "Ordo" group (Ordo Kreis) there were two differing, if not distinct, strands: a group of economists, of whom the leading figures were Walter Eucken, Franz Böhm, and Fritz Meyer, based at Freiburg; and a number of more socially oriented thinkers, the "exiles" Wilhelm Röpke, Alfred Müller-Armack (who coined the phrase "social market economy"), and Alexander Rüstow.[16] It should be noted, however, that none of the latter, with the possible exception of Müller-Armack, had a doctrine that bore much resemblance to Scandinavian welfarism. Of great significance is the fact that West Germany's first Economics Minister, Erhard, was closely associated with Ordo.

Before examining in detail the economic and political thought of the social market economy, it might be helpful to look briefly at the circumstances in which it arose.[17] From 1936 to 1948, during both the Hitler and the Allied Occupation periods, the German economy was subject to rigid

[16] Most of the major works of the Ordo group are now available in English. See *Standard Texts on the Social Market Economy* (New York: Ludwig Erhard Institute, 1982). Especially important individual works are: Walter Eucken, *The Foundations of Economics* (Edinburgh: William Hodge, 1951), and *This Unsuccessful Age* (Edinburgh: William Hodge, 1951); Wilhelm Röpke, *The Social Crisis of Our Time* (Edinburgh: William Hodge, 1950), and *A Humane Economy* (London: Wolf, 1960).

See also Konrad Zweig, *The Origins of the German Social Market Economy* (London: Adam Smith Institute, 1980); *Germany's Social Market Economy: Origins and Evolution*, ed. Alan Peacock and Hans Willgerodt (London: Macmillan, 1989); and *German Neo-Liberals and the Social Market Economy*, ed. Alan Peacock and Hans Willgerodt (London: Macmillan, 1989).

[17] For a historical account, see Gustav Stolper, *The German Economy: 1870 to the Present*, new edition, revised by Karl Hauser and Knut Borchadt (London: Weidenfeld and Nicholson, 1967), pp. 219–72.

controls. But price fixing, rationing, and a hopelessly inefficient monetary system (the reichsmark was worthless) had produced ruinous economic results: output plummeted, the black market flourished, and barter had replaced normal monetary exchange. Full employment was maintained, but only by a system which produced goods that nobody wanted. The Allied Occupation powers, engaged in the process of denazification, were determined that West Germany should not have a liberal market economy. In fact, the economic advisers at the time were Keynesian and broadly sympathetic to economic planning. However, it was realized that currency reform was essential, and Ludwig Erhard (chief official of the Administration for Economic Affairs for the British and American Occupation Zones), used the occasion of the establishment of the new deutschemark to secure (by the use of not a little chicanery)[18] the immediate lifting of a whole range of price and other controls. Erhard simply let the market operate freely in the new regime of monetary stability. He specifically did not use an expansionary budget to mop up the unemployment that inevitably appeared as an immediate consequence of the removal of controls.

This was greeted with skepticism by the Allied economists. None other than John Kenneth Galbraith was economic adviser to the American Military Government, and he made the following comment on the liberalization program: "There has never been the slightest possibility of getting German recovery by this wholesale repeal [of price controls], and it is quite possible that its reiteration has delayed Germany's recovery. The question is not whether there must be planning . . . but whether that planning has been forthright and effective."[19] Yet the subsequent events showed Galbraith, and almost all conventional economic observers at the time, to be spectacularly wrong.

As the liberalization of the hitherto controlled economy proceeded throughout the late 1940s and early 1950s, West Germany quickly recovered. From 1953 to 1963, GNP grew at an annual average rate of 6.7 percent, compared with 4.7 percent in France and 2.7 percent in Britain.[20] Alongside that of Britain, West Germany's performance in industrial output and exports was phenomenal, and by the 1960s the country was on top of the European economic league. Although factors other than the social market economy were important, such as a surplus of labor from Eastern Europe which reduced pressure on wages and ensured (relative)

[18] The three military governments had little idea what to do about the West German economy but probably favored the continuation of the controls. Erhard simply went ahead with the liberalization without asking their permission. He gambled that the success of the measures would make them irreversible. See Hans Willgerodt, "Planning in West Germany: The Social Market Economy," in *The Politics of Planning*, ed. A. Lawrence Chickering (San Francisco: Institute for Contemporary Studies, 1976), pp. 61-82.

[19] Quoted in *ibid.*, p. 64.

[20] See A. Gruchy, *Comparative Economic Systems* (Boston: Houghton Mifflin, 1977), ch. 5.

trade-union docility, the application of that particular economic philosophy was instrumental in securing this remarkable transformation.

There was no *Wirtschaftswunder* (economic "miracle") but merely the result of the pursuit of well-tried economic orthodoxies (although at the time they were almost radical). Some credit must be given to Erhard, as senior Economics Minister in the Adenauer government, for sticking to free-market principles against many pressures, ideological as well as political. Nevertheless, there was no "pure" market economy in postwar West Germany. There were many state interventions, of which perhaps the most significant was the deliberate use of fiscal policy to encourage personal savings.[21]

It is a significant fact that the social market economy was imposed on the German people. Most commentators doubt that it had much support from the major political groups, including the Christian Democrats, who were wedded to a kind of Christian socialism; and but for the ruinous situation at the time, it might never have been given a hearing. It is also pertinent to note that Germany's defeat had effectively destroyed all those special-interest groups that had succeeded in undermining the market system in Britain.[22] However, once the success of the social market economy became manifest, the doctrine came to be embraced by all the political parties, although the Social Democrats did not formally abandon Marxism until 1959.

Despite the devastation of war, there were some features peculiar to Germany which made it propitious for the establishment of a market economy. Although productive capacity was badly damaged by war, the effect should not be overestimated.[23] What was left was still serviceable in comparison to the vast tracts of more or less unusable heavy industry bequeathed by Communism. Although the Nazis had operated a command economy, it had functioned through a system of private ownership (heavily cartelized though it was) and private law (heavily compromised though that had become). Most important of all, there still existed significant social and intellectual capital invested in market arrangements, even though it required considerable replenishing. In comparison, most former Communist regimes will have to be marketized *ab initio*.

Nevertheless, there is one startling similarity. Former Communist regimes, if they are to introduce successfully a free-market economy, are likely to do so in a nondemocratic context. This is not to say that market arrangements, in principle, are unpopular, but rather than in the immediate short-term it is likely that a coalition, consisting of those who benefit from the status quo, could form against particular market proposals if they were put to an immediate vote. The market system is itself a pub-

[21] Tax incentives were offered to encourage investment, especially for house-building. There were also subsidies to agriculture and selected industries.

[22] Mancur Olson, Jr., *The Rise and Decline of Nations* (New Haven: Yale University Press, 1982), pp. 129-33.

[23] Braum, *German Economy in the Twentieth Century* (see n. 15 above), ch. 8.

lic good, the benefits of which go to unknown people and, in the case of former Communist regimes especially, at unknown dates. We are already seeing evidence of this in Poland, where there has been a significant retreat from earlier economic reforms. This is largely the result of the recent election (1991), which led to the downfall of the market-oriented government. The Polish parliament is now splintered into a myriad of factions, out of which it will be difficult to form a coalition favorable to radical reform. This is why large swaths of unproductive industry have remained immune from change. Similar phenomena are visible in the republics of the former Soviet Union, whose legislatures still consist largely of unreconstructed Communists.

The Germans were advantaged in having their first postwar general election in late 1949, *after* the reintroduction of the market and when its benefits were just showing. But it took some time to secure overwhelming support (not the least of the opposition came from the Christian socialist wing of Erhard's own party, the Christian Democratic Union).

I have no doubt that some version of the same lesson will apply to the former Communist regimes. The benefits of marketization will be too slow in coming for there to be an automatic endorsement of the new arrangements. Those governments that introduce them are likely to suffer electoral retribution. In West Germany, however, the introduction of the deutschemark and the rapid removal of price controls produced only a short-lived inflation, since there was already in place productive capacity to respond to the new demand in a manner sufficient to endear the population to the new regime (albeit precariously at first). The transition to the new monetary system involved some injustice because of the way in which the vast amount of money in the form of the reichsmark was taken out of circulation. Put simply, each citizen could only exchange sixty reichsmarks for sixty deutschemarks on a one-to-one basis. Above this, a citizen's credit balance was convertible at a ratio of ten reichsmarks to one deutschemark. This disadvantaged those who had held their assets in cash in comparison to those who owned property (which was automatically revalued in terms of the deutschemark). This injustice was to some extent remedied in later legislation, which imposed special levies on the holders of property and other assets that had not been devalued by the monetary reform.[24] There are certain to be similar, if not greater, injustices in monetary transformations in former Communist regimes.

II. The Doctrine

The doctrine of the social market economy, if it is to have any plausible exportability, must be seen in two aspects. First, it must be seen as a

[24] This was achieved by the Equalization of Burdens Act passed in 1952. For a description of the currency reform, see Dennis L. Bark and David R. Gress, *A History of West Germany: Vol. I, From Shadow to Substance* (Oxford: Blackwell, 1989), pp. 198–209.

normative account of an economic "constitution," i.e., a system of social relationships that describes not merely the private property, free exchange system, but also those moral, legal, and political rules without which it is not sustainable. They are in some significant ways different from those that feature in Anglo-American classical liberalism. Second, the doctrine must be seen as the set of welfare and redistributive measures that happened to emerge in the later development of the West German economy. Although both these aspects feature in Ordo writings (which, in fact, cover a range of opinion within a broad liberal framework), the latter measures were treated with considerably more caution by the authors than they were by the politicians, and many writers argued that certain measures, for example, the introduction of unfunded state pensions and other high-cost social-security policies, were incompatible with the original doctrine.

It was probably a number of perversions of the original idea that led to classical-liberal skepticism of the theory. Indeed, a prominent second-generation Ordo theorist, Hans Lenel, was to pose in 1971 the question: "Do we still have a social market economy?"[25] In Hayek's view,[26] the addition of the word "social" to the noun "market" was either an adjectival frill (all market relationships are necessarily social) or the illegitimate imposition of some arbitrary redistributive purpose on an otherwise self-developing and self-correcting spontaneous order.

Undoubtedly, it is the second aspect of the social market economy that has proved *politically* attractive, but Hayek's criticism has been a constant source of confusion. Historically, the success of the West German system was achieved by the implementation of more or less free-market measures between 1948 and 1952,[27] and though collectively they had a "purpose," it did not at that time have much to do with social justice or any other of the rationalistic end-states that have since been proposed. Of the social market economy thinkers only Müller-Armack[28] envisaged a "Second Phase" of the social market in explicitly redistributivist terms. In his view, the state must, in effect, "tame" the market in order to achieve what he called an "irenical" (balanced and harmonious) order. I think it is fair to say that other Ordo theorists, such as Eucken, Böhm, and Röpke, believed that a properly organized market and legal order would necessarily narrow the ambit of the state.

[25] Hans Lenel, "Does Germany Still Have a Social Market Economy?" in *Germany's Social Market Economy* (see n. 16 above), ch. 17.

[26] See Friedrich Hayek, "What is Social? What Does it Mean?" in Hayek, *Studies in Philosophy, Politics, and Economics* (London: Routledge and Kegan Paul, 1967), pp. 237–44.

[27] Hans Lenel, "Evolution of the Social Market Economy," in *German Neo-Liberals* (see n. 16 above), ch. 2.

[28] Alfred Müller-Armack, "The Principles of the Social Market Economy," *German Economic Review*, vol. 3, no. 1 (1965), p. 94. See also his "Economic Systems from a Social Point of View," in *Economy and Development*, ed. J. Thesing (Mainz: Konrad Adenauer-Stiftung, 1979), pp. 95–122.

The reason why controversy arose over the precise meaning of the social market economy (and its connection with capitalism) is that theorists such as Eucken, Böhm, and Röpke (all of whom had serious doubts about welfare and redistribution, at least in the form that those are customarily achieved) were as critical of laissez faire as they were of any overt redistributivist doctrine. Röpke wrote that: "Like pure democracy, undiluted capitalism is intolerable";[29] Erhard was "unwilling to accept without reservation and in every phase of development the orthodox rules of a market economy according to which only demand and supply determine price";[30] and Eucken argued that "experience of *laissez-faire* goes to prove . . . that the economic system cannot be left to organize itself. So there is no question of any return to *laissez-faire*."[31] Still, although these theorists and practical men did not believe that the "just" wage equaled marginal productivity, they did not therefore endorse a Scandinavian-style welfare state.

They did not mean that the market was ethically deficient because it did not meet some explicit redistributive goal, but rather that its survival was imperiled if it were not underpinned by a complex set of moral and legal rules and if it showed no concern for its potential victims. Thus, it is not sufficient to demonstrate the utility-maximizing virtues of markets; the German theorists were concerned equally to stress the importance of those institutional arrangements which make exchange feasible (primarily an autonomous legal order that is, to an extent, independent of the state). The realization that the market would not secure a wide social legitimacy if it were not made compatible with some degree of state-decreed welfare led Eucken, Röpke, Böhm, et al. to accept those social-security arrangements that had long been a feature of German life. There is, indeed, evidence of the lingering influence of Christian socialism in some social market economy thinking.

It is this version of the social market economy which is of direct relevance to the former Communist regimes, whose transition to liberal capitalism will be hazardous, and their experience of it short-lived, if it is seen as a mere exchange system. Thus, if fair property rules that are to govern both acquisition and transfer are not established, the system will lack legitimacy; if there is no system of private law, disputes between individuals will be irresolvable and anarchy will probably ensue; if there is unlimited democracy, the state will become prey to pressure groups; and if no concern is shown toward those harmed by markets, capitalism will have an insecure ethical foundation. The last point indicates that the former Communist regimes will have to maintain elements of the old wel-

[29] Röpke, *Social Crisis of Our Time* (see n. 16 above), p. 119.

[30] Ludwig Erhard, *Prosperity Through Competition* (London: Thames and Hudson, 1958), p. 102.

[31] Eucken, *This Unsuccessful Age* (see n. 16 above), p. 93.

fare system, no matter how inefficient it is, since a successful transition to capitalism will inevitably involve hardship as old and useless industries are liquidated.

Thus, the real debate between classical liberalism and Ordo liberalism was not just about redistribution but about the latter's denial of the extreme version of the spontaneity thesis, i.e., the belief that a total social system requires very little in the way of guidance and control. Neither the free-exchange system nor its legal concomitant could be left to themselves, the Ordo theorists argued. Unlimited freedom of contract would lead, it was claimed, to the undermining of liberty, because contractors would contract into cartels, monopolies, and so on, which would lead to the closure of the market.[32] Without careful design, government would dispose favors to pressure groups, especially protectionist measures. The limited state of laissez-faire theory, operating through uncorrected private law, would be unable to maintain order, justice, predictability, and, ultimately, the market system itself. In Röpke's work especially, it was further argued that moral relativism, so characteristic of much of classical-liberal thought, would generate nihilism. He was, in fact, a proponent of objective natural law.[33]

There is no doubt that this skepticism about the self-correcting features of the market under a simple version of private law was influenced by a feature of twentieth-century German economic history: this was cartelization, the gradual closure of the market. This had proceeded apace in the first thirty years of the twentieth century: the Hitlerian command economy was run through monopolies and cartels which had long been invulnerable to competition. According to Rüstow, it was the state's "lamentable weakness"[34] that was the problem, and this weakness, in combination with an unregulated market, made totalitarianism possible. This looks, superficially, as if it is the reverse of the classical-liberal claim, i.e., that a diminution of the range of state authority, outside its public-good functions, necessarily increases individual liberty. Does the doctrine of the social market economy have then the startling implication that the former Communist countries need a strong state?

This is, of course, misleading and only appears to be the case because some writers (primarily Rüstow) in the Ordo tradition used an idealized, or sanitized, neo-Hegelian conception of the state; they saw it as an impartial body that exists to regulate the conflicts within civil society while itself remaining resistant to the overweening demands of any subset of that society. The possibility of such an institution permanently operating this way has been thoroughly undermined by public-choice theory.

[32] *Ibid.*, pp. 31–33.

[33] Röpke, *Social Crisis of Our Time*, p. 4.

[34] Quoted in C. J. Friedrich, "Political Thought of Neo-Liberalism," *American Political Science Review*, vol. 49, no. 4 (1955), pp. 509–25.

A more sustainable version of the Ordo doctrine posits a distinction between state and economic society, with both being regulated by law[35] — the ideal of the *Rechtsstaat* (rule-of-law state), in fact. One of the most pressing tasks of the former Communist countries, then, if they are to follow Ordo, is to put all public authorities under the rule of law. For example, it was the impossibility of suing the state under Communism that made the pollution problem strictly speaking intractable, for there were no methods by which social pressure could be translated into corrective action.

III. Economic Constitutions

Thus, the first priority for Eastern European and former Soviet regimes is to establish an "economic constitution" on the lines suggested by Eucken.[36] This comprises constitutive and regulatory principles. Briefly, constitutive principles govern money, private property, freedom of contract, open markets, and personal liberty for action. But following these *alone* could lead to the self-destruction of the market, and they have to be supplemented by regulatory principles (which actually dilute the classical liberalism contained in the constitutive principles) if freedom is to be preserved. These regulatory principles cover, for example, the regulation of the money supply to prevent inflation and deflation (though not for contra-cyclical policy) and the abolition (not merely control) of monopolies. The state and the constitution cannot be "neutral" but must protect an *order of liberty*, not just individual choice. And this can only be done by taking certain things out of the realm of politics. Thus, if there is a coherent end-state in the theory of the social market economy, it is not social justice but ordered liberty, as distinct from negative liberty.

Leaving aside the question of the original designation of property titles, the above might seem to be a reasonable set of recommendations for a newly established liberal market society: one that must unavoidably, in Eastern Europe, come about by design. Still, it is worth analyzing the extent to which the regulatory principles *should* dilute the constitutive principles. Do the newly emerging economies require that type of regulation of competition approved by all Ordo writers? As those writers recognized, the problem of monopoly is better dealt with by private rather than public law, by litigation rather than hands-on regulation. Monopolies, and certainly cartels, can indeed arise in open economies, but two points are relevant here. First, they are precarious and vulnerable to competition if the market is kept open. Second, monopoly profits can be a reward for genuine entrepreneurship, acts of discovery in the market which create

[35] See Franz Böhm, "The Rule of Law," in *Germany's Social Market Economy* (see n. 16 above), ch. 4.

[36] Eucken, *Foundations of Economics* (see n. 16 above), pp. 80-121.

new value.[37] In economies freeing themselves from central control, a state-directed competition policy, derived from abstract theories of perfect competition, may well impede economic progress, just as anti-trust law in the U.S. and monopoly policy in the U.K. have obstructed processes of benign industrial integration. These processes are vulnerable to public law because they look as if they are anti-competitive.

What is needed is not cumbersome public law, which may well be counterproductive and itself subject to pressure-group influence, but private law which is protective of individual rights to compete in the market. The cartel problem in Germany arose out of a highly controversial *Reichtsgericht* (Supreme Court) decision in 1897 which upheld a contract that was blatantly in restraint of trade.[38] It is quite consistent with orthodox liberal theory to maintain that competition is a public good which the courts, through private law, should protect.

It will be easier for a newly emerging economy to develop without anti-competitive monopolies if the law enforces international free trade, since this always poses a threat to any market-closing agreement which might be smuggled in under private law. There is a distinction between a conspiracy against the public good of open competition (which the 1897 case involved) and the emergence of apparent concentrations of ownership. The latter are not necessarily harmful. As long as the state maintains the market order, such concentrations will always be vulnerable to competition. Still, as the Ordo theorists appreciated, there is the danger that concentrations of wealth may generate inequalities of political power.

There is some disagreement among observers as to whether cartelization, even in the extreme form it took in Germany, was a threat to market efficiency. In fact, what probably motivated the Ordo group was not so much the economic argument but a more important political consideration, i.e., the fact that the cartelization of German industry, and the growing concentration of ownership, made the rise of a totalitarian command economy possible.

Thus, anti-cartelization and pro-competitive interventionist policies were pursued vigorously in the postwar years—but with, apparently, varied success. Some Ordo thinkers maintained that the original anti-cartelization law (1957) allowed too many exemptions for certain industries.[39] However, there is a curious irony here, for some of the success of the social market economy may be due to the absence of the strict form of anti-trust

[37] See Israel Kirzner, *Competition and Entrepreneurship* (Chicago: University of Chicago Press, 1973).

[38] For a brilliant analysis of this issue, see Jan Tumlir, "Franz Böhm and the Development of Economic-Constitutional Analysis," in *German Neo-Liberals* (see n. 16 above), ch. 6.

[39] See Werner Möschel, "Competition Policy from an Ordo Point of View," in *German Neo-Liberals*, ch. 7. For the argument that cartelization was not a serious problem for the German economy, see H. C. Wallich, *Mainsprings of the German Revival* (New Haven: Yale University Press, 1955), p. 139.

legislation that prevails in the United States. What is also important here is the relatively "closely held" nature of German corporations, in which banks and other institutional shareholders play an important supervisory role. Some observers say that such corporations are relatively invulnerable to takeovers and hence able to plan for the long term without having to worry too much about short-term share-price fluctuations.[40] Such a development is consistent with the theory of spontaneous order.

Two other important social implications follow from these observations—implications which may have relevance for former Communist regimes. First, German industrial enterprises display a "social conscience"[41] which inhibits their managements from indulging in the wholesale plant restructuring and relocation that characterizes industrial change in Anglo-American liberal capitalist economies. Corporate raiders are regarded with a certain amount of social disdain (as they are in the U.S.). However, what is probably more decisive here is the fact that the structure of ownership in German industry allows for close monitoring of management by shareholders. In the "loosely held" corporation of the United States and Britain, the takeover threat is the only mechanism that shareholders have for disciplining management. Also, in Germany, trade unions have a role in management, including representation on the boards of public companies. These features make for a more intimate style of economic relationship in Germany, which contrasts with the aggressive, "arm's length" attitudes of American industrialists and financiers. The former may be more appropriate for regimes trying to come to terms with capitalism.

Secondly, it is undoubtedly the case that, rightly or wrongly, entrepreneurial profits (especially those of financial intermediaries) earned in American industrial reorganization offend popular notions of social justice (primitive though these may be). Of course, apologists for liberal capitalism have coherent explanations for these profits, but an understanding of them requires some sophistication and indeed considerable experience of the sometimes arcane workings of capitalism. It is probably true that all of the original theorists of the social market economy would have been disturbed by the apparently bizarre distributions of incomes thrown up by financial markets in Anglo-American capitalist systems. No one could accuse Eucken and other social market theorists of lacking economic sophistication.

These are speculative thoughts which may be disproved by events. Already the takeover mentality may be influencing industrial organization in Germany (and the rest of continental Europe). Nevertheless, they do suggest that some features of Anglo-American capitalism, especially the anonymity of the forces that drive it and the indifference to its outcomes

[40] Eric Owen Smith, *The West German Economy* (London: Croom Helm, 1963), ch. 7.
[41] *Ibid.*, p. 213.

that its major spokesmen proclaim, are not easily exportable. They belong, perhaps exclusively, to communities whose inhabitants are prepared to accept the discipline of abstract rules and to conduct their lives according to the constraints of (an often costly) formal law rather than compromise their individuality by the informal enforcement of more extensive social obligations. This attitude is not to be dismissed. Indeed, it represents a considerable human achievement and one which has generated immense prosperity. However, as the Ordo group was anxious to stress, in ruinous situations, its apparent moral relativism and its toleration of a certain kind of gratification may not be conducive to social order.

IV. Politics and the Degeneration of the Social Market Economy

Yet there is clearly some confusion in the original theory of the social market economy between the effectiveness of moral restraints on egoism and a reliance on fortified institutional arrangements to generate stability. It could be argued that what is lacking in Eucken's "economic morphology"[42] is a set of prescriptions for those political rules that should form a *written* economic constitution. In a sense the demand for competition from the Ordo group did not go far enough: it did not extend to the political arena. No mention is made of the possibility that the *Wirtschaftsordnungspolitik* (the order of economic society) might best be preserved by competition between political institutions: giving polities (and individuals) the "exit" option in fact. In most existing federal systems (including Germany's), the predominant feature is not competition between component units for the delivery of a range of public services but, rather, the allocation of these services to the various units (fiscal federalism). This is certainly true of America, whose original genuine federalism has ceased to exist. The states are little more than administrative units of a centralized state.[43]

It is argued by some sympathetic critics of the social market economy that it was the lack of adequate constitutional arrangements embodying political competition that led to the degeneration of the original ideal: as evidenced by the inexorable rise in government spending (now around 44 percent of GDP) since the 1950s, the emergence of budget deficits, the imposition of heavy nonwage labor costs on employers, and the persistence of subsidies to agriculture and industry.[44]

[42] This is Eucken's instructive phrase; see his *Foundations of Economics*, pp. 85-90.

[43] Federalism seems to exist in the U.S. only in a "representational" form; i.e., the states are represented in Congress but lack the original constitutional protection of their authority. This seems to have been confirmed in a U.S. Supreme Court decision in 1985 (*Garcia v. San Antonio Transit Authority*). See Thomas R. Dye, *American Federalism: Competition Among Governments* (Lexington: D. C. Heath, 1990), ch. 1.

[44] See Walter Hamm, "The Welfare State at Its Limit," in *Germany's Social Market Economy*, ch. 12. For a philosophical critique of the welfare state, see Röpke, *Humane Economy* (see n. 16 above), pp. 156-80.

The real exception is the survival of the principle of a sound currency; one feels that this has been as much due to a "taboo" against inflation as it has to the strict rules that obligate the Bundesbank (formally established in 1957). It is a taboo the origins of which can be traced to Germany's disastrous experience of hyperinflation in the 1920s. All German opinion leaders are very much aware of the political as well as the economic consequences of inflation. But there was a shift to neo-Keynesian contracyclical macroeconomic policies in the late 1960s and the emergence of a kind of "planning." All this was even given a name—the enlightened market economy.[45]

There was, however, a principle in the original theory of the social market economy to govern government intervention. It was known as *marktkonform*.[46] A policy is *marktkonform* if it aids the market system (even if it is redistributive) rather than impedes it. Thus, aid (cash) to the homeless is *marktkonform*, rent control is not; a negative income tax for the poor is, fixing a minimum wage is not; most forms of protectionism are not *marktkonform*. It is a superficially attractive principle, combining as it does the criterion of efficiency and the imperative of compassion.

It is, however, a deceptive principle, since it is obvious that any redistributive policy must have some effect on the market. This calls for another principle to determine just how many market impediments are acceptable. It is not inconceivable that massive redistributive measures could be validated under the rubric of *marktkonform*. In any case, the typical interventionist measures associated with the later development of the social market economy could by no stretch of the imagination be made consistent with the original ideas of Ordo liberalism.

The history of the development of counterproductive welfare measures in postwar West Germany reflects similar processes that were taking place in other Western democracies. The reproduction of conventional democratic procedures in the Basic Law of the Federal Republic led to a gradual increase in the power of pressure groups—the absence of which had been so significant in the rejuvenation of the economy from its almost ruined state in 1948. Röpke et al. were certainly aware of the debilitating effect of some forms of group action on an economic and political order. None was more so than Eucken, who was keenly aware (in a nonformal way) of the public-good features of the total system of economic and political arrangements. As he observed: "Many men are genuine experts in their own economic environment, but they are unable to weigh up dispassionately the wider interrelationships."[47] What he had in mind were those groups that sought exemption from the rule of law and protection

[45] See Norbert Kloten, "The Role of the Public Sector in the Social Market Economy," in *German Neo-Liberals* (see n. 16 above), ch. 4.

[46] Röpke, *Social Crisis of Our Time* (see n. 16 above), pp. 160–62. For a critique of *marktkonform*, see Gerard Radnitzky, "The Social Market and the Constitution of Liberty," in *Britain's Constitutional Future*, ed. Frank Vibert (London: Institute of Economics, 1991), pp. 6–8.

[47] Eucken, *Foundations of Economics*, p. 29.

from economic competition. What was required, then, was not merely a constructivist act in the creation of an order but attention to the need for its repair in the context of more or less universal human motivations. Müller-Armack's hope that the social market economy would generate a personality that belonged neither to laissez faire nor to socialism was an illusion.

V. The Social Market Economy and Post-Communism

It is unfortunate that the social market economy being offered to former Communist regimes is the one regarded as degenerate by admirers of the original theory. It is said to be so, not because the original version excludes a type of welfare (although most theorists argued that increased prosperity brought about by the market would reduce the need for collective provision), but because it has proved to be costly and because it developed in an ad hoc way. Also, it was said to undermine personal responsibility and individual autonomy—the ethical principles of the original social market economy. The *Wirtschaftsordnungspolitik* was flawed in its direct constitutional manifestation. In the end, politics triumphed over the market.

What prevents an easy application of the original principles of the social market economy to Eastern Europe and the former Soviet Union is the absence there of crucial features, notably stable money, a system of private law, and a structure of property rights. Of equal importance is the fact that in the former Soviet Union there is little understanding of the *meaning* of market relationships; more specifically, the idea that two-person exchange is mutually beneficial is only reluctantly accepted, if it is accepted at all. Furthermore, decades of central planning have deprived citizens of knowledge of rational banking and accounting practices.[48] The only advantage they have is that there is much more outside intellectual support for their transformation into European-style market economies than there was for the similar venture in postwar Germany.

The tasks that are involved in the rational construction of civil order are obvious enough, but how to meet them is mind-numbing in its complexity. Of course, the construction of an economic constitution cannot be identical for all the emerging market systems, since no order can be designed in isolation from particular cultural traditions. In terms of immediate economic problem solving, the former East Germany is at an obvious advantage compared to the ex-Soviet republics, and its absorption into an already successful market system makes it almost a special case. In other European former Communist countries, the task is one of recovering a

[48] See Ronald McKinnon, *The Order of Economic Liberalization* (Baltimore: Johns Hopkins University Press, 1991).

lost tradition of law and commerce; in Russia and other similarly located regions, the change involves a step into the unknown. What is required of them all, however, is the establishment of an overarching system of rules which protects the civil society of private law, a private economy, and voluntary associations: a predictable order in which politics has an assigned role, not an all-embracing one.

The most immediate necessity is the construction of a system in which economic value is determined by the subjective opinions of market transactors rather than by the arbitrary dictates of political authorities. However, a market economy cannot perform this task without a system of property rights which are protected by private law. Israel Kirzner's theory of entrepreneurship is unhelpful in a context in which property entitlements are unknown; the market signals that will indicate scarcities in a regime of decontrolled prices will be ineffective if there are no private arrangements through which potential producers can respond to the lure of profit; and all will be in vain if there is no efficient productive system which can turn black markets (the only "economies" that worked under Communism) into white markets. West Germany was to some extent freed from those problems in 1948, but because of their all-pervading presence in the former command economies of today, the scope for conscious direction and control is, superficially at least, wider. It is imperative, however, that political control should be limited to the construction of the rules of economic order and not extended to guiding that order in any particular direction. That was, indeed, the agenda of the theory of the German social market economy.

Privatization is a case in point. At the moment it is assumed by most Western observers that the vast industrial tracts of much of Eastern Europe and the former Soviet Union are pretty much worthless. But nobody can know this until a market has been formed, and this cannot be effective without property rights. Yet if the industries are disposed of by state agencies it is almost inevitable that the sale will be influenced by political factors. The government will not want to be seen as selling off national assets too "cheaply," especially in the context of newly established democratic electoral politics. Yet, given the extraordinarily high risks attached to most purchases, potential buyers will be looking for high returns. It is certain that the fear of unemployment and the disruptive reallocation of resources which is predicted to follow necessary and rapid disposals will inhibit the politicians from allowing the market to operate properly. Furthermore, the likelihood that foreign investors will be the only ones capable of taking the high risks (in return for high rewards) will inflame nationalist sentiments. Already in the former East Germany it is apparent that the *Treuhandanstalt*[49] (the state selling agency) is putting onerous

[49] See Amity Shlaes, "Germany's Treuhand—A Too Visible Hand," *Wall Street Journal Europe*, January 3, 1992.

conditions, derived from the degenerate social market economy, on potential purchasers; they include the preservation of existing industries and of employment levels.

Privatization is the most obvious solution, but privatization in Eastern Europe is vastly different from experiments in the West, especially Britain's. Here selected state industries were successfully sold off to the public through a sophisticated merchant banking system and in the context of a functioning market economy which was already supplying some information about the values of the assets to be disposed. In former Communist regimes there is very little information precisely because markets have been suppressed for decades.

In these circumstances the best solution is probably that being tried in Czechoslovakia (1992): the method of popular share distribution devised by Vaclav Klaus.[50] Under the plan most of the country's eleven million adults purchased books of vouchers at a very low cost (thirty-six dollars per book). The vouchers entitled the owners to make bids for shares in two thousand of the country's enterprises, covering an enormous range of activities (which were given an original notional value). Once distributed, the shares can be bought and sold and the true values of the enterprises will then emerge through the normal process of supply and demand. To prevent atomization of share ownership, most of the stock is being owned through mutual funds, although the Czech parliament limited mutual-fund ownership to 40 percent of every enterprise. No doubt this limitation will be evaded. But it is difficult to see why that should necessarily be harmful, since in the early stages of privatization some concentration of ownership will be extremely useful in order to monitor managements.

It is, of course, far too early to evaluate the scheme. One problem is that individuals may wish to dispose of their assets quickly for cash. This would cause a massive fall in the price of shares, enabling foreign investors to buy up vast tracts of Czech industry very cheaply. Still, the government itself had already sold off some valuable assets to foreigners before the privatization process. At least under the latter scheme the people will be aware of the fact that it is *they* who have sold off the nation's assets. This should deflect criticism from the government. Furthermore, given the perilous state of the Czech economy, the population should welcome any inflow of foreign capital.

One must assume that the Czech-style transformation into capitalism will only be possible in certain parts of the former Communist world: Eastern Europe and possibly the Baltic states. In those areas that completely lack a commercial tradition, the former republics of the Soviet

[50] See Peter Passell, "A Capitalist Free-for-All in Czechoslovakia," *New York Times*, April 12, 1992.

Union, history will have to be "concertina-ed." Europe's evolutionary process of capitalist development will have to be compressed into a short period—or not emulated at all, for the recent freedom experienced may well reveal to some peoples that the forced industrialization of the twentieth century, brought about by a "modernistic" Communism, was a catastrophic error. The opening of international trade might show that Russia's comparative advantage lies in agricultural production. This, of course, means that collectivized agriculture will have to end and that a proper system of individual property rights will have to be restored to land ownership. Whatever industry does remain will have to be justified economically and not retained for purposes of national pride or for the pointless maintenance of full employment at any price.

The real reason why the problems of liberalization are especially difficult for the republics of the former Soviet Union is that civil order has apparently broken down. Experiments in economic reform of any kind will have to be postponed until some semblance of order is restored to fractious and ethnically divided regions. This was not a problem faced by postwar Germans, who could rebuild the market economy in a homogeneous population whose territory (though divided) was secure. Thus, the kind of regulation of economic life permitted by the theory of the social market economy was predicated upon the prior establishment of cultural and political integrity. Only in Poland, Hungary, and the Czech part of Czechoslovakia[51] does that exist. Elsewhere, the existing political circumstances indicate that Thomas Hobbes rather than Adam Smith provides better insights into the conditions necessary for social survival.

The relationship *between* the states of former Communist regimes will be crucial, and here the lessons of the social market economy are relevant. As a competitive order, the system is, in theory, one that stresses diversity and genuine decentralization. This of course derives from the epistemological doctrine of the dispersed nature of social knowledge. All the early theorists had firsthand experience of central planning and had analyzed its errors. However, they were writing about particular economies rather than the relationships between national economies. But their notion of freedom theoretically includes the idea that competition between national economies is an essential ingredient in economic progress. This notion of freedom involves not merely free trade in goods and services but competition between nations in the offering of different laws and institutions, and of course the right of free movement of labor and capital.

In international terms this implies that any grouping of states should

[51] At the time of writing, it is apparent that the Czechoslovak republic is about to break up into Czech and Slovak entities. The future Slovak republic is almost certain to be less market-oriented and more nationalistic than its erstwhile partner.

be loose and confederal, with few compulsory transnational laws and regulations. The ultimate threat of exit from such a grouping is the only mechanism that can ensure the preservation of competition. Thus, the way that the European Community is developing should not constitute the model for any international association of former Communist states. Ludwig Erhard had fears that the (then) European Economic Community would develop into a protectionist bloc, and he was skeptical of the imposition of uniform industrial and welfare standards.[52] In this he was, of course, remarkably prescient. This is already happening with the "social chapter," which purports to impose common regulatory norms across member states and will ultimately reduce the competitive advantage, in crucial areas, that the poorer members now have. The intention is that they will be compensated by the richer ones through significant interregional transfers. All this is of course anti-competitive and hence productive of "Eurosclerosis." The policy of "harmonization" of industrial practices currently pursued by the Commission of the European Community would be fatal if it were applied to any grouping of former Communist states, given the variety of economic conditions prevailing among them. And behind all this stands the economically crass but politically immovable Common Agricultural Policy.

The original social market economy was deficient in not extending the ideal of competition into the political arena. The former Communist regimes, which consist in many cases of fragile political units, could remedy this defect by forming associations, the members of which could compete with each other in the supply of economic constitutions. Even forms of market socialism and co-determination,[53] which might have some favorable cultural antecedents in special areas, would not be excluded in an international competitive context.

Conclusion

Thus, only some features of the social market economy outlined above are feasible for the former Communist regimes. The decisive factor is not just that these countries are simply incapable of meeting the demands set by what I have called the degenerate version of the system: the equally important point is that this mutation included the partial abandonment of those competitive arrangements that are the prerequisites of economic and social stability. There is a variety of differing (if not competing) strains within the theory of the social market economy: the temptation for for-

[52] See Bark and Gress, *History of West Germany* (see n. 24 above), p. 385.

[53] Co-determination, i.e., the involvement of workers' representatives in the management of companies, was an early innovation in the West German economy. However, the power of final decision on key issues is left with the owners. See *ibid.*, pp. 269-70.

mer Communist regimes to choose the most politically attractive rather than the most economically feasible might be irresistible.

Whatever economic arrangements are proposed, they are dependent upon a prior stable political order, a point constantly emphasized by Ordo liberals. The theory of the spontaneous development of social institutions is likely to be tested as never before in former Communist regimes, lacking as they do so many of the cultural conditions that were present in the earlier developments of markets and private-law systems.

Politics, University of Buckingham